

Social Security COLA Reductions Would Weaken Financial Security for the Oldest and Poorest Retirees

Richard W. Johnson, Joshua H. Goldwyn, and Melissa M. Favreault

Cost-of-living adjustments (COLAs) for Social Security beneficiaries are a frequent target for reform. Last February, Federal Reserve Board Chairman Alan Greenspan recommended cutting retirement benefits by reducing COLAs (Greenspan 2004).¹ He argued that these inflation adjustments are overly generous because they are based on the change in the consumer price index (CPI), which most experts agree overstates the true increase in the cost of living. Although this reform would save Social Security money, it would also create financial problems for some retirees, especially those at advanced ages who have been receiving Social Security benefits for many years. Some even argue that COLAs are not generous enough because many older Americans spend heavily on health care, which has been rising more rapidly in cost in recent years than most goods and services.

Nearly everyone agrees that some change to Social Security is necessary, as the growing size of the older population threatens to bankrupt the system. Projections estimate only 27 working-age adults (age 20 to 64) for every 10 senior citi-

zens (age 65 and older) in 2040, down from 48 working-age adults in 2000 (Board of Trustees, Federal Old-Age Insurance 2004). This growing imbalance means fewer workers to pay taxes to finance retiree benefits.

This brief examines the consequences of potential Social Security COLA reforms on the incomes of older Americans. Because the effects of COLA changes accumulate during retirement, the full impact of any reform implemented now would not be felt for many years. As a result, we project individual financial outcomes in 2040, by which time even the oldest beneficiaries would have spent virtually all of their retirement years under the reformed COLA rules. We model the potential impact on median Social Security benefits and the share of older adults with limited incomes. We also examine how the outcomes would vary by economic status.

The results show that cutting Social Security COLAs along the lines suggested by Greenspan would substantially reduce family incomes for the oldest and most vulnerable retirees. For adults age 85 and older, median Social Security benefits would be 13 percent lower in 2040 after the COLA cuts than they would be under current rules. The impact would be much smaller for relatively young beneficiaries, who already receive more Social Security income than older beneficiaries because benefits are based on career earnings. COLA cuts would prove especially painful for those with limited incomes, and would push millions of older adults onto the bottom rungs of the income distribution.

Social Security COLAs and the CPI

Social Security benefit payments automatically increase each year by the percentage change in the CPI.² These increases, known as COLAs, help maintain the purchasing power of retirement benefits, and have become increasingly important as life expectancy rises and retirees spend more years collecting benefits. For example, a

woman who retires today at age 65 can expect to live another 19 years (Board of Trustees, Federal Old-Age Insurance 2004). If the inflation rate were 3 percent per year, the real value of Social Security benefits would decline by 43 percent during her expected lifetime without the automatic increase. Since other sources of retirement income, such as private pensions and savings, generally do not adjust for cost of living, Social Security provides one of the few means of inflation protection available to older Americans.

CPI May Exaggerate Changes in the Cost of Living

Questions persist, however, about how well Social Security COLAs reflect changes in the true cost of living for older Americans. Research suggests that the CPI overstates the true rate of inflation. The CPI estimates changes in the price level by computing the cost to consumers of purchasing a fixed basket of goods and services at different points in time. However, this basket becomes less representative as consumer spending patterns change in response to price changes and new choices. For example, consumers may replace products that rise in price with less expensive substitutes, lowering the true increase in the cost of living below the change in the CPI. Similarly, consumers may respond to higher prices by finding less expensive outlets where they can shop. Improvements in the quality of products, which can enhance durability and reduce the cost of repairs, are not well measured, further biasing the estimates upward. In addition, new products are added to the market basket with long lags, if at all, so that the CPI basket may not always accurately reflect the types of products consumers purchase.

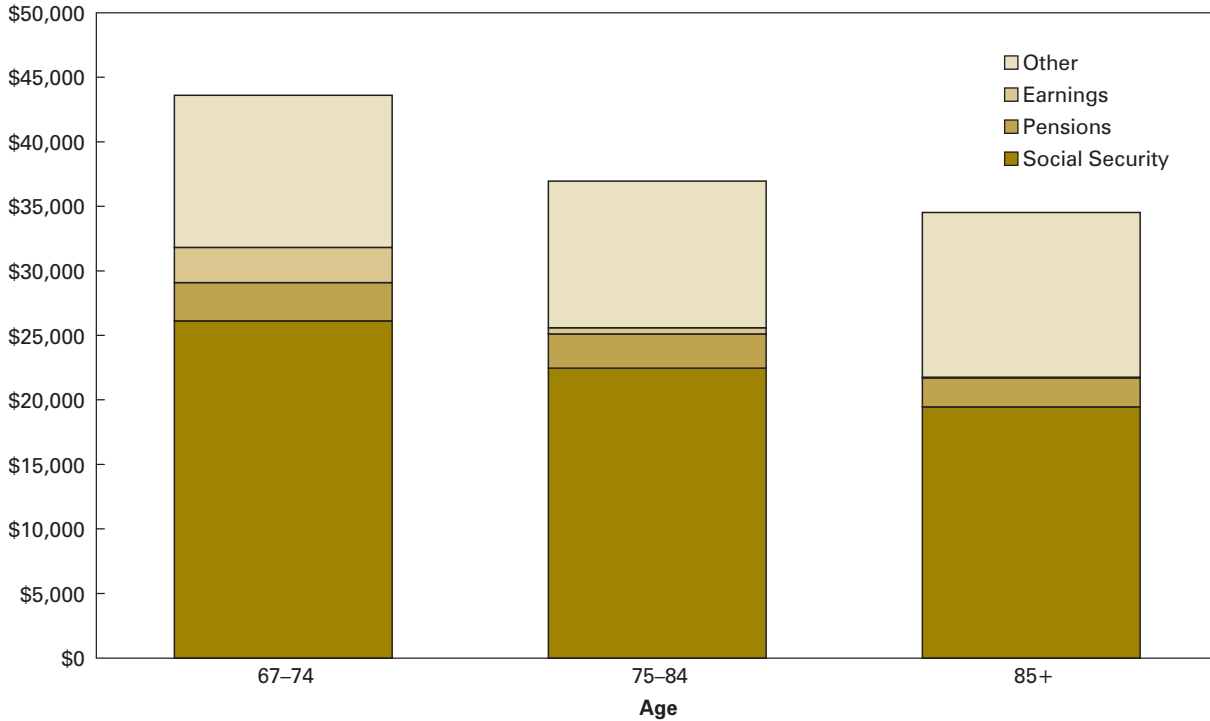
The Advisory Commission to Study the Consumer Price Index (1996), more commonly known as the Boskin Commission, concluded nearly 10 years ago that these factors have led the CPI to overstate the true increase in the cost of living by 1.1 percentage points per year. Partly in response to the commission's recommendations, the Bureau of Labor Statistics (BLS) instituted a

number of technical changes in the late 1990s in the way it computes the CPI. The Congressional Budget Office (1999) estimated that these changes reduce the annual growth in the CPI by about 0.7 percentage points per year.

More recently, the BLS introduced the chained CPI, an experimental price index that better accounts for the tendency of consumers to purchase less expensive substitutes when the relative price of a particular good or service rises. The use of the chained CPI further slows the apparent growth in the cost of living. Between December 1999 and December 2003, the new experimental index grew nearly 0.5 percentage points per year more slowly, on average, than the standard CPI.

Because the standard CPI appears to overstate increases in the true cost of living, even after technical changes were implemented in the late 1990s, a number of policymakers have called for changes in the way the government computes Social Security COLAs. For example, Senators Bob Kerrey (D-NE) and Daniel Patrick Moynihan (D-NY) introduced a bill in 1998 that would have reduced COLAs to 1 percentage point below the annual percentage change in the CPI. Other reform advocates, including Greenspan, Representatives Jim Kolbe (R-AZ) and Charlie Stenholm (D-TX), and members of the 1994–96 Advisory Council on Social Security, have proposed revising the CPI or using the chained CPI instead of the standard CPI to adjust benefits. Such proposals would ease the economic burdens of providing public retirement benefits to the rapidly growing older population, but the reductions could also threaten the financial security of many retirees. Cuts could disproportionately affect the oldest and poorest beneficiaries. We project, for example, that family income for the typical adult age 85 or older will reach only \$34,500 in 2040 (measured in today's dollars), \$9,000 less than family income for the typical adult between the age of 67 and 74 (figure 1). And Social Security benefits will account for more than half of family income at the oldest ages, compared with just more than one-quarter of family income at age 67 to 74.

FIGURE 1. Median Family Income of Social Security Beneficiaries under Current Law, by Age and Type of Income, 2040



Source: Urban Institute computations from DYNASIM3.
 Note: Financial values are expressed in constant 2004 dollars.

Older Americans with the lowest incomes are also particularly dependent on Social Security and would be especially vulnerable to benefit cuts. For example, we project that Social Security benefits will account for more than 80 percent of total family income in 2040 for adults age 67 and older in the bottom quarter of the income distribution. By contrast, Social Security will account for less than 25 percent of total family income for those in the top quarter of the distribution. Reducing Social Security COLAs, then, could have the sharpest effect on those who can least afford cutbacks in their retirement benefits.

CPI May Understate Price Changes and Health Costs at Older Ages

Primarily because the use of health services tends to increase with age, older consumers face steeper price hikes than younger consumers.

Over the past 10 years, the medical care component of the CPI has increased nearly twice as fast as the overall index. Consider Medicare Part B premiums, just one component of health care spending in which almost all older people pay for coverage of physician and other selected services through Medicare. These premiums have grown by 46 percent in the past four years alone—to \$60.66 per month in 2004—and are projected to increase by another third over the next five years (Medicare Board of Trustees 2004). Rising medical costs hit older Americans especially hard because health care accounts for a disproportionate share of their budgets. In 2002, for example, households headed by adults age 65 and older devoted 13 percent of their spending to health care, compared with only 4 percent for households headed by adults age 35 to 44 (U.S. Bureau of Labor Statistics 2004a).

The CPI used in Social Security COLA calculations does not fully reflect the impact of rising

health costs on older adults. Benefit changes are based on the CPI for urban wage earners and clerical workers (CPI-W), not the better-known CPI for all urban consumers (CPI-U). The CPI-U, which is used to adjust the official federal poverty thresholds, federal tax brackets, and many government benefits, represents the spending habits of about 87 percent of the population, and virtually everyone living in metropolitan areas. The CPI-W, by contrast, represents only 32 percent of the population, and covers only urban households that include employed wage earners or clerical workers whose earnings account for at least one-half of the household's income (U.S. Bureau of Labor Statistics 2001).

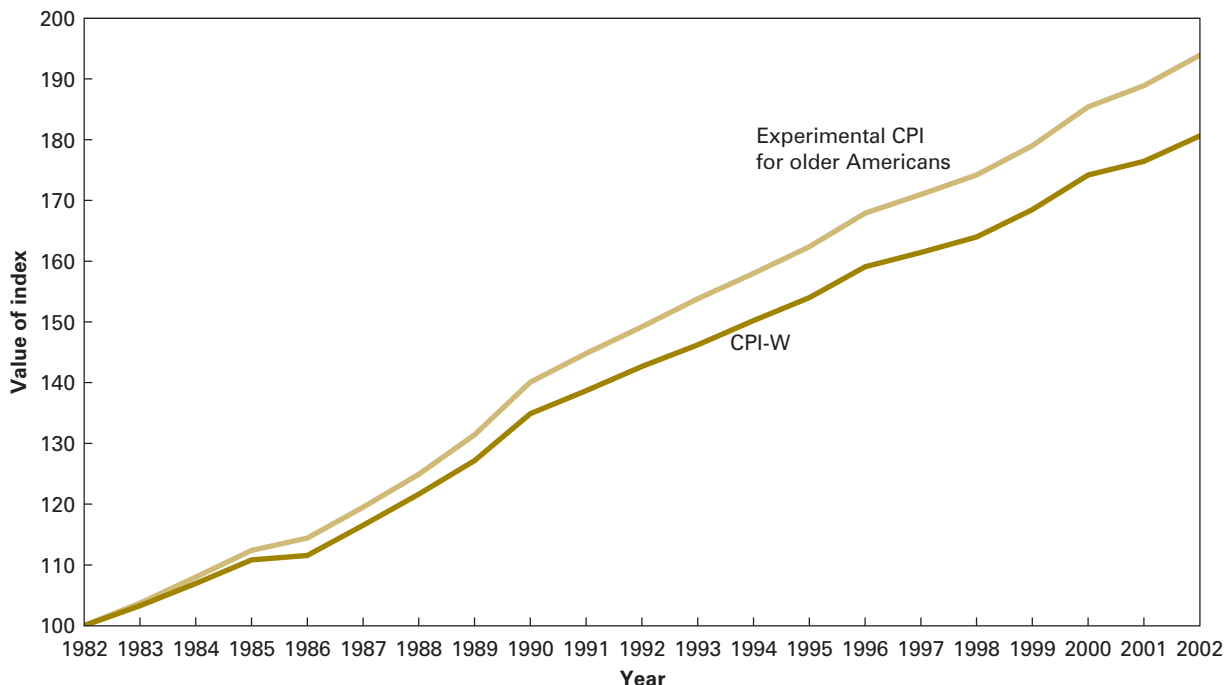
To maintain living standards for older Americans during their long retirement years, policymakers may need to raise Social Security COLAs above the true change in price levels faced by younger Americans. The Bureau of Labor Statistics now computes an experimental CPI based on the spending habits of households headed by adults age 62 and older.³ Between

1982 and 2002, the experimental price index grew, on average, 0.4 percentage points faster each year than the CPI-W (figure 2). Over the 20-year period, this differential increased prices 7 percent more for older consumers than for urban wage earners. Tying COLAs to changes in the experimental CPI for older Americans would likely closely offset any reductions from the use of the chained CPI, suggesting that the existing COLA formula may provide a fairly accurate measure of true price changes for Social Security beneficiaries.

Estimating the Impact of COLA Changes

To assess how changes to Social Security COLAs or the CPI might affect older beneficiaries, we simulate economic outcomes for older Americans in 2040 under four different scenarios. The baseline case assumes that Social Security will continue to pay benefits as specified under current law. The other three scenarios assume that

FIGURE 2. Growth in the CPI-W and Experimental CPI for Older Americans, 1982 to 2002



Sources: Bureau of Labor Statistics (2004b) and private communications with BLS staff.

Congress changes the Social Security COLA formula in 2004.

- In the first reform scenario, we set the COLA equal to 0.5 percentage points less than the annual percentage change in the CPI, approximately equal to the difference between the existing CPI and the chained CPI and consistent with the reforms that Greenspan recently advocated.
- The second reform scenario sets the COLA equal to 1 full percentage point less than the annual percentage change in the CPI.
- In the final reform scenario, we assume that the CPI is set equal to 0.4 percentage points greater than the annual percentage change in the CPI, approximately equal to the difference between the CPI-W and the experimental CPI for older Americans.

The simulations are based on the Urban Institute’s *DYNASIM3* model, a dynamic microsimulation model that forecasts future demographic, social, and economic characteristics of the population by simulating births, deaths, marriages, divorces, work decisions, and earnings.⁴ The model accounts for many of the forces transforming society that will shape future

retirement outcomes over the next half century, including improvements in productivity, increases in women’s employment and earnings, the growing racial and ethnic diversity of the older population, and changes in retirement behavior and private pensions. The model uses the intermediate assumptions adopted by the Social Security trustees, which forecast an annual increase in the CPI of 2.7 percent in 2004, 2.9 percent in 2005, and 3 percent in all future years. We restrict the analysis to those age 67 and older because Social Security’s normal retirement age will be 67 for new retirees by 2040.

Projected Impact on Social Security Benefits

Cutting Social Security COLAs would exacerbate age differences in Social Security benefits. Table 1 shows how changes to the COLA formula would affect median Social Security benefits in 2040 for beneficiaries age 67 and older. Overall, lowering the COLA to 0.5 percentage points below the annual percentage change in the CPI would reduce median annual Social Security income in 2040 for beneficiaries age 67 and older by about 8 percent, or \$1,600 in today’s dollars, relative to

TABLE 1. Median Annual Social Security Income for Adults Age 67 and Older, under Current Law and Alternative COLA Reforms, 2040

	Current law	COLA = change in CPI – 0.5 pct points		COLA = change in CPI – 1 pct point		COLA = change in CPI + 0.4 pct points	
	Median income (\$)	Median income (\$)	Percent change	Median income (\$)	Percent change	Median income (\$)	Percent change
All	20,700	19,100	-7.7	17,700	-14.5	22,200	7.2
By age							
67-74	23,300	22,200	-4.7	21,200	-9.0	24,300	4.3
75-84	20,100	18,300	-9.0	16,700	-16.9	21,700	8.0
85+	17,800	15,500	-12.9	13,500	-24.2	19,900	11.8

Source: Urban Institute computations from *DYNASIM3*.

Notes: The sample is restricted to Social Security beneficiaries age 67 and older. Under current law, Social Security COLAs equal the percentage change in the CPI. The analysis assumes that COLA changes were implemented in 2004. Percent changes are computed as median Social Security income under the COLA reform minus median income under current law, divided by income under current law. All financial values are expressed in constant 2004 dollars.

what income would be under current rules. But the cut would hit those in their 90s and late 80s more than twice as hard as those in their 70s and late 60s because the effects of COLAs cumulate over time once retirees begin receiving benefits. Cutting COLAs along the lines suggested by Greenspan would reduce median benefits by 13 percent for those age 85 and older, compared with only 5 percent for those age 67 to 74. Benefits in 2040 would fall even further if COLAs were limited to 1 full percentage point below the change in the CPI, dropping by 24 percent at age 85 and older and by 9 percent at age 67 to 74.

Sweetening COLAs, on the other hand, would especially benefit the oldest retirees. Setting COLAs at 0.4 percentage points above the change in the CPI—to account for the rapid growth in health care costs faced by older Americans—would raise median annual Social Security benefits in 2040 by 12 percent (or more than \$2,000 in today’s dollars) for those age 85 and older, compared with a 4 percent increase for those age 67 to 74.

Projected Impact on Family Incomes

Changing Social Security COLAs would disproportionately affect those with limited incomes because Social Security accounts for more of their family income. Table 2 shows how COLA changes would alter average family income in 2040 for adults age 85 and older, who would be most affected by reform.⁵ The table also sorts the population by income, divides members into 10 groups of equal size (known as deciles), and reports outcomes for each group. The first row shows average income for those in the first group, whose projected 2040 income under current law falls in the bottom 10 percent of the distribution. Each successive row shows results for the group in the next highest income range.

For those in the first income group, average family income in 2040 would fall by 12 percent—to \$8,300 in today’s dollars—if COLAs were trimmed to 0.5 percentage points below the change in the CPI, and by 22 percent if COLAs were cut to 1 full percentage point below the CPI change. The relative impact falls steadily with

TABLE 2. Average Family Income for Adults Age 85 and Older by Decile, under Current Law and Alternative COLA Reforms, 2040

Deciles of family income	Current law	COLA = change in CPI – 0.5 pct points		COLA = change in CPI – 1 pct point		COLA = change in CPI + 0.4 pct points	
	Average income (\$)	Average income (\$)	Percent change	Average income (\$)	Percent change	Average income (\$)	Percent change
First	9,400	8,300	-11.7	7,300	-22.3	10,400	10.6
Second	15,200	13,400	-11.8	12,000	-21.1	16,600	9.2
Third	19,900	17,800	-10.6	16,000	-19.6	21,700	9.0
Fourth	24,900	22,800	-8.4	21,000	-15.7	26,700	7.2
Fifth	31,200	28,900	-7.4	26,900	-13.8	33,200	6.4
Sixth	38,200	35,800	-6.3	33,600	-12.0	40,400	5.8
Seventh	47,800	45,200	-5.4	43,000	-10.0	50,100	4.8
Eighth	62,100	59,300	-4.5	56,900	-8.4	64,700	4.2
Ninth	90,500	87,500	-3.3	84,900	-6.2	93,200	3.0
Tenth	252,800	249,500	-1.3	246,500	-2.5	255,800	1.2

Source: Urban Institute computations from DYNASIM3.

Notes: The sample is restricted to Social Security beneficiaries age 85 and older. Under current law, Social Security COLAs equal the percentage change in the CPI. The analysis assumes that COLA changes were implemented in 2004. Percent changes are computed as mean family income under the COLA reform minus mean income under current law, divided by income under current law. All financial values are expressed in constant 2004 dollars.

income. With the 0.5 percentage points cut, average family income would fall by only 7 percent for those in the fifth income group and by only 1 percent for those in the top group.

Increasing COLAs, however, would most benefit those with the least income and provide a relatively simple way to target additional benefits to those most in need. For example, boosting the COLA to 0.4 percentage points above the change in the CPI would raise average family income in 2040 by 11 percent for those in the bottom income group, but by only 1 percent for those in the top group.

Projected Impact on Older Adults with Low Incomes

The drop in Social Security benefits following a COLA reduction would substantially increase the number of older Americans with limited incomes. The impact would be especially severe among the oldest beneficiaries. Table 3 shows the projected number and share of adults age 67 and older in 2040 with low family incomes under current rules and under the three potential COLA reforms. Trimming COLAs by one-half percentage point each year would raise the number of adults age 67 and older with low incomes in 2040

by 1.8 million, and lowering COLAs by a full percentage point would raise the number by 3.6 million, compared with outcomes under current law. Reducing COLAs to one-half percentage point below the change in the CPI would raise the share of adults age 85 and older with low family income by 4 percentage points, to 28 percent of the population.

Boosting COLAs by 0.4 percentage points per year, on the other hand, would reduce the number of low-income older adults by 1.6 million and shave the share of adults age 85 and older with low incomes by 4 percentage points.

We set the threshold for low-family income equal to one-half the average economywide wage. In 2002, this threshold was approximately equal to 150 percent of the poverty threshold for older couples, a common indicator for the minimum amount of income needed to meet basic consumption needs.⁶ Only 8 percent of full-time workers had family incomes below this threshold in 2002.⁷ Our measure, then, identifies older adults with fewer financial resources than the vast majority of working Americans.

Summary and Implications

Reducing Social Security COLAs to improve the solvency of the system would lead to sharp cuts

TABLE 3. Number and Share of Adults Age 67 and Older with Annual Family Income Less than 50 Percent of Average Economywide Annual Earnings, under Current Law and Alternative COLA Reforms, 2040

	Current law		COLA = change in CPI – 0.5 pct points		COLA = change in CPI – 1 pct point		COLA = change in CPI + 0.4 pct points	
	Number (millions)	Share (%)	Number (millions)	Share (%)	Number (millions)	Share (%)	Number (millions)	Share (%)
All	13.4	18.0	15.2	20.4	17.0	22.7	11.8	15.9
By age								
67–74	4.1	14.4	4.4	15.7	4.9	17.2	3.7	13.2
75–84	5.7	19.7	6.5	22.3	7.3	25.0	5.0	17.3
85+	3.6	23.4	4.3	27.8	4.8	31.2	3.1	19.8

Source: Urban Institute computations from DYNASIM3.

Notes: The sample is restricted to Social Security beneficiaries age 67 and older. Under current law, Social Security COLAs equal the percentage change in the CPI. The analysis assumes that COLA changes were implemented in 2004.

in retirement benefits and incomes for older beneficiaries with limited resources, and push millions of older adults onto the bottom rungs of the income distribution. Trimming COLAs along the lines suggested by Greenspan would reduce average incomes in 2040 by 12 percent for those age 85 and older in the bottom 10 percent of the income distribution. These cuts would also leave nearly 2 million additional older people with little income. By contrast, beneficiaries who receive substantial amounts of income outside of Social Security and younger beneficiaries—who generally receive higher benefits than those in their 80s and 90s—would feel little pain from the cuts.

Policymakers should pursue reforms that more closely tie Social Security escalators to the true increase in the cost of living at older ages, but they should not arbitrarily reduce COLAs. Continued efforts to improve the CPI make sense, so that movements in the price index better measure the true change in the cost of living. These technical changes would likely reduce the future growth in the CPI. But policymakers should also consider tying COLAs to changes in the experimental CPI for older Americans, to better reflect the steep increases in the cost of health care that older people face. These two reforms could closely offset each other. In fact, existing Social Security COLAs may do a good job of reflecting true price changes for beneficiaries.

Social Security reforms are necessary to restore long-run solvency, but policymakers must be careful to protect the most vulnerable beneficiaries. Other reform proposals, such as increases in the retirement age or across-the-board cuts in benefits, also pose special risks for those with low lifetime earnings and health problems. The best solution to the financing crisis would include moderate benefit reductions and revenue increases to bring the system back into balance. If COLAs are reduced, the cuts should be combined with other reforms, such as increases in the minimum benefits payable by Social Security, enhancements to the needs-based Supplemental Security Income program, and changes to the benefit formula to increase the share of pre-retirement earnings that Social

Security replaces for low-income workers. Social Security must be reformed soon, but not at the expense of the oldest and poorest beneficiaries.

Notes

1. He also recommended increasing the age of eligibility for Social Security and Medicare and tying future increases to changes in life expectancy.
2. Increases equal the percentage change between the average value of the CPI for the third quarter of the year and the average for the third quarter of the previous year. Benefits increase the following January.
3. For additional information on the experimental CPI for older consumers, see Amble and Stewart (1994).
4. *DYNASIM* was originally developed at the Urban Institute in the 1970s and has been updated over the past few years. *DYNASIM3* has been used recently to simulate the potential impact of various proposed Social Security reforms. For more information about *DYNASIM3*, see Favreault and Smith (2004).
5. Family income includes all sources of income received by older adults and their spouses, if married. It also includes the annual income that couples and unmarried individuals would receive if they converted 80 percent of the financial assets they held in 2040 into annuities. Our measure excludes any income received by other people who might be living in the household.
6. In 2002, the average annual economywide wage was \$33,252 (Board of Trustees, Federal Old Age Insurance 2004), and the poverty threshold for older couples was \$10,885 (U.S. Social Security Administration 2004).
7. This estimate is based on data from the March 2003 Current Population Survey.

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T H E R E T I R E M E N T P R O J E C T

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The Retirement Project is a research effort that addresses how current and proposed retirement policies, demographic trends, and private-sector practices affect the well-being of older individuals, the economy, and government budgets.